

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR: [REDACTED]: POSTF-165564-01
[REDACTED]

date: **04 APR 2002**

to: LMSB Team [REDACTED]

Attn: [REDACTED]

from: Area Counsel
(Natural Resources:Houston)

subject: [REDACTED] - [REDACTED] and [REDACTED]

Depreciation - [REDACTED] - [REDACTED] Cycle

Taxpayer: [REDACTED]

EIN: [REDACTED]

Last Known Address: [REDACTED]
[REDACTED]

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum is in response to your request for Area Counsel Advice on the below described issues. We have deemed this advice to be nondocketed significant advice. The current document incorporates the changes suggested by the National Office ten day review. The analysis has been slightly modified from the original draft sent to you on March 20, 2002, but the conclusions are unchanged. Please feel free to incorporate this advice into your work on the audit of the above-referenced taxpayer. The attachments are those sent on March 20, 2002.

ISSUES

1. Whether [REDACTED] containing no [REDACTED] are "placed in service" for purposes of depreciation deductions.

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2. Whether unlit [REDACTED] in [REDACTED] are "placed in service" for purposes of depreciation deductions.

3. Whether the Service should require more detailed information on the cost of [REDACTED] than a mere admission that substantial costs are involved.

CONCLUSIONS

1. [REDACTED] containing no [REDACTED] are not "placed in service" for purposes of depreciation deductions.

2. [REDACTED] which have not been [REDACTED] are not "placed in service" for purposes of depreciation deductions.

3. The Service should insist on more detailed information on the cost of [REDACTED] than a mere admission that substantial costs are involved.

FACTS

Background

[REDACTED]

[REDACTED]

[REDACTED]

FSA 200146028 (August 9, 2001) (hereinafter "FSA") on the allocation of costs between long-term construction contracts and taxpayer-owned, self-constructed assets for the above-referenced taxpayer. This advice covered the [REDACTED]-[REDACTED] audit cycle. The FSA determined that the taxpayer's use of the incremental cost method of accounting for purposes of allocating costs between long-term construction contracts and taxpayer-owned self-constructed assets did not clearly reflect income. In the current cycle, the taxpayer continues to use the incremental method of accounting for determining its taxable income in connection with the building of a [REDACTED] for itself and customers. There are, however, four significant changes in the underlying facts between the current cycle and the prior cycle. The information on changes 1-3 are background for the issues involved herein, change 4 contains the facts relevant to the depreciation issues.

The changes are:

1.

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

2. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] Agreement

[REDACTED]

1 [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

2

[REDACTED]

3

[REDACTED]

[REDACTED]

Term

[REDACTED]

Maintenance Provisions

[REDACTED]

[REDACTED]

4 [REDACTED]

[REDACTED]

[REDACTED]

Insurance Provisions

[REDACTED]

Taxes

[REDACTED]

Regeneration Facilities

[REDACTED]

[REDACTED]

's Treated as Sales and Purchases

[REDACTED]

Right of Way Agreements

[REDACTED]
:

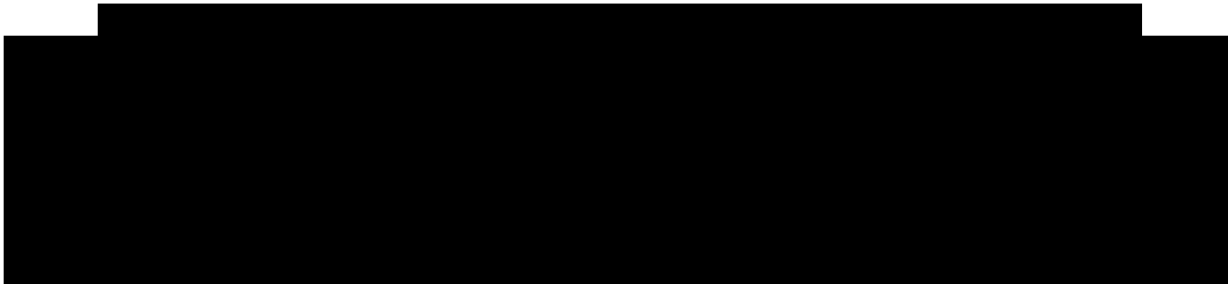
[REDACTED]

[REDACTED]



Easement Agreement, [REDACTED].

Project Accounting--Examples of Actual Cost Allocation



3. [REDACTED] Changes Its Method of Accounting for Financial Purposes.

The third change in the underlying facts is that for financial accounting purposes, [REDACTED] changed its method of accounting for the conduit projects in the current cycle to what is referred to as an average method. For tax purposes, however, [REDACTED] continued to use the incremental method. In the prior cycle, [REDACTED] had used the incremental method for both book and tax purposes.

Attachment 4 shows [REDACTED]'s comparative financial results under the average cost method for the same project illustrated in Attachment 3 under the incremental method. Under this latter method, [REDACTED]

This method of allocated resulted in a positive net cash flow of \$[REDACTED], the projected profit of [REDACTED] on this segment.⁷

[REDACTED]'s current vice president for Finance and Tax indicated that the reason for the change from the incremental cost method of accounting to the average cost method on the financial statement was to "[REDACTED]." [REDACTED] needed additional

⁶ Very preliminary and incomplete data indicate that [REDACTED] allocates the cost of the regeneration facilities by square footage of usage. [REDACTED]

⁷ Even in this model, however, [REDACTED] applied the [REDACTED]'s [REDACTED] percent to a [REDACTED] cost where [REDACTED] percent of the costs of [REDACTED].

capital to continue to build the [REDACTED] and did not want to disclose a contingency loss on the financial statement related to the option to sell [REDACTED] an additional [REDACTED] at a later date.⁸ Per the Statement of Position of Long Term Contracts (SOP 81-1), the cost of the additional [REDACTED] would need to be shown as a loss when finished if the incremental cost method of accounting were used. If [REDACTED] used the average cost method of accounting, however, a loss would not result and a contingency loss would not have been disclosed. In actual fact, [REDACTED] never "sold" the additional [REDACTED] to [REDACTED]. Rather, these [REDACTED] were "sold" to the entities listed in Attachment 5.

Subsequent Contracts on the Same Segments--Attachment 5

As stated earlier, the Agreement provides that [REDACTED]
[REDACTED]
On the [REDACTED] segment, however, [REDACTED] actually pulled [REDACTED]. On the first contract for the [REDACTED] segment with [REDACTED] in the examples used above, [REDACTED] "sold" [REDACTED] of the [REDACTED] pulled [REDACTED] to [REDACTED]. [REDACTED] itself retained [REDACTED].⁹ [REDACTED] subsequently "sold" the remaining [REDACTED] on this segment as follows: [REDACTED]; [REDACTED]¹⁰; [REDACTED]. See Attachment 5.

Attachments 6 and 7 show the cash flow results from an [REDACTED] contract with [REDACTED] almost identical to that with [REDACTED] for the [REDACTED] segment. Attachment 6 shows the application of the incremental cost method of accounting; Attachment 7 the average cost method. As can be seen in Attachment 6, [REDACTED] has a positive cash flow, or projected profit, for tax purposes of \$ [REDACTED], representing [REDACTED] percent of the cash receipts from [REDACTED]. This is in contrast to the negative cash flow, or projected loss, of \$ [REDACTED] on the [REDACTED] contract for the [REDACTED] [REDACTED], and which negative amount exceeded the revenue from the Agreement on that segment.

This vastly different result between the [REDACTED] and [REDACTED] contracts is explained by the fact of embedded costs. These are those costs incurred in connection with the initial project which

⁸ To date, [REDACTED] has not purchased the additional [REDACTED].

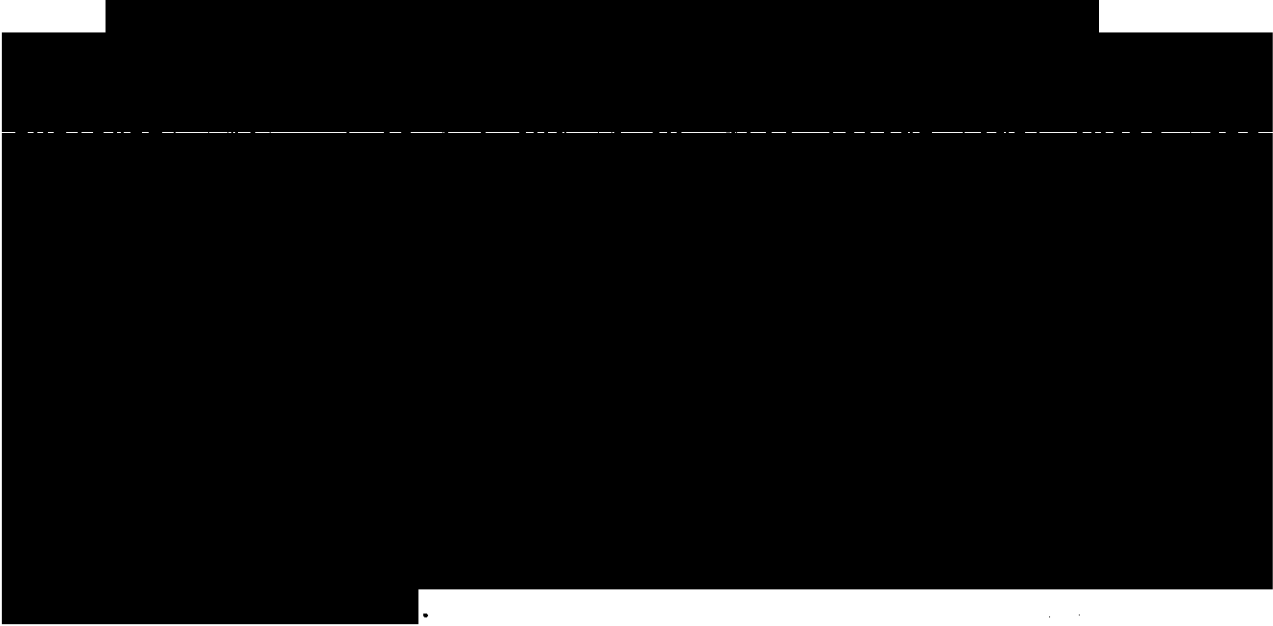
⁹ As of [REDACTED], the date of Attachment 5, however, [REDACTED] still retained [REDACTED].

¹⁰ "[REDACTED]" [REDACTED]
[REDACTED].

were expensed on that project, but a part of the asset of which is transferred to subsequent buyers on the segment. For example, although percent of the material and labor cost of the first was allocated to the cost of goods sold on the contract, , to which also sold in the same , is using the same portion of that with its . As all of the costs of the were allocated to , none were left to allocate to .

4. Commences Depreciation of the

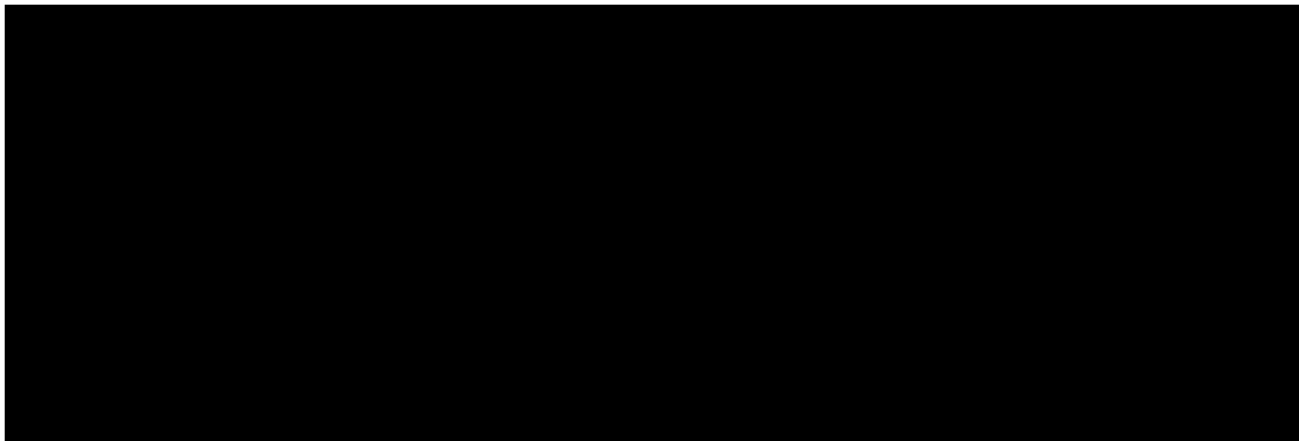
The fourth change in facts from the prior cycle is that the taxpayer began claiming significant depreciation deductions for empty and in the year.¹¹ , of course, had capitalized the cost of through which the had been pulled to the Agreement, so there was nothing to depreciate there. But began depreciating the empty spare at this time.



¹¹ There are some indications that possibly placed a minor amount of assets in service in the prior cycle of - . The agents are presently attempting to verify this.

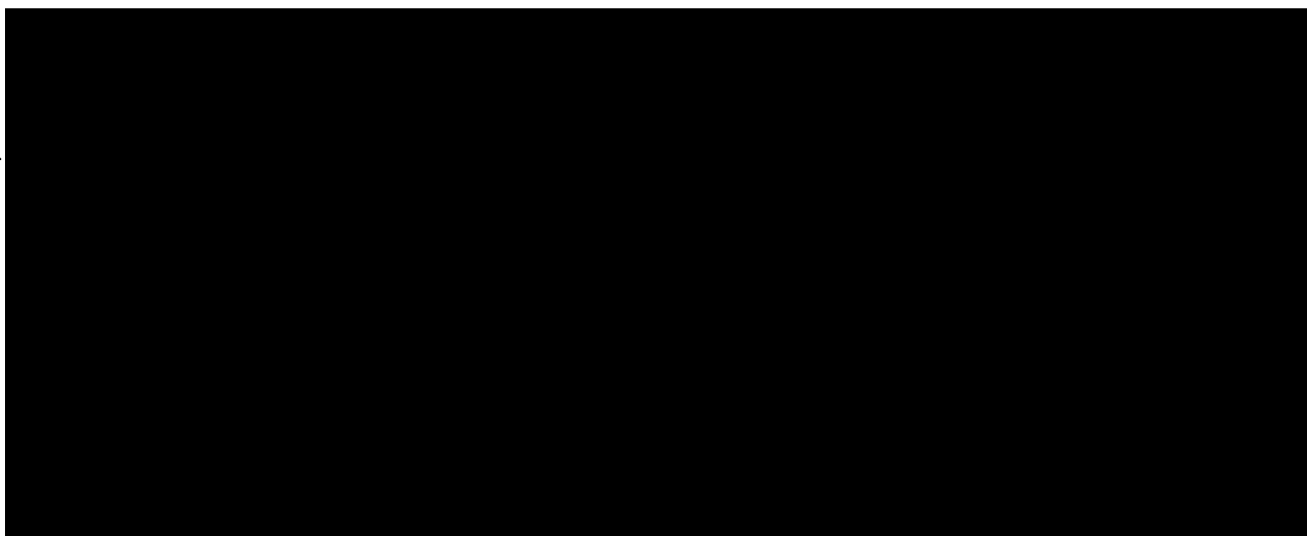
On the [REDACTED] tax returns for the periods ending July 31, [REDACTED] and [REDACTED], the costs related to the [REDACTED] have been treated as follows:

TABLE 1

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For tax purposes, the [REDACTED] were treated as follows:

TABLE 2

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The result of this depreciation scheme is that [REDACTED] is depreciating assets with a cost basis of approximately \$[REDACTED] [REDACTED] in connection with the [REDACTED] route.

If the costs of the segment had been allocated in accordance with the average method to clearly reflect income, [REDACTED] would be depreciating assets with a cost basis of \$ [REDACTED]. This is illustrated in the follow table.

Table 3-

Date	Time	Location	Weather	Remarks

Technical facts on [REDACTED] system

[illegible]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

Costs involved to bring spare [REDACTED] and [REDACTED] into use

With respect to the spare [REDACTED], [REDACTED] would have to incur substantial costs to make the [REDACTED] operational. Take again the example of the [REDACTED] segment. To make the first [REDACTED] operational, [REDACTED] incurred approximately \$[REDACTED] to pull the [REDACTED] through the [REDACTED] and \$[REDACTED] for the cost of the [REDACTED] itself. Then there would be the costs of [REDACTED] the pulled [REDACTED]. The total of this amount would then need to be multiplied many times to cover the entire [REDACTED]

(b)(7)a

[REDACTED]

(b)(7)a

(b)(7)a

(b)(5)(AC), (b)(7)a

Although the Service has requested this information from the taxpayer, [REDACTED]

Preliminary indications from the general literature in the area of [REDACTED] are that activation of the [REDACTED] is a costly and complex process and not simply a matter of flipping a switch. There are some statements that it costs far more to [REDACTED] than to install it. [REDACTED]

On the matter of the costs which would have to be incurred to light [REDACTED], [REDACTED] was asked the following IDR # [REDACTED] question on [REDACTED]: "Was the needed equipment, to light all [REDACTED], owned & available for use when the [REDACTED] depreciation commenced?" In response, [REDACTED] stated that it "[REDACTED]". From this answer, we conclude that [REDACTED] did not have the equipment needed to [REDACTED] the [REDACTED] as of [REDACTED] and [REDACTED] and would need to expand capacity in order to [REDACTED].

Further, [REDACTED] was asked: "What equipment is involved to [REDACTED]? Does each [REDACTED] require its own equipment or can equipment service multiple [REDACTED]? To this, [REDACTED] responded: "[REDACTED]"

" (b)(7)a

(b)(7)a [REDACTED]

[REDACTED] Prospectus

When [REDACTED] went public in [REDACTED], the following statements were contained in its Prospectus.

[REDACTED]

[REDACTED] Prospectus at [REDACTED].

This prospectus further states:

[REDACTED]

[REDACTED] Prospectus at [REDACTED].

[REDACTED]

[REDACTED]

The LMSB examiner has made some determinations based on these definitions as applied to the information stated in the above quoted section of the [REDACTED]. Specifically, [REDACTED] percent ([REDACTED]) of the [REDACTED] would need to be lit to equal the transmission capacity of the initially activated [REDACTED].

DISCUSSION

Law

Section 167(a) provides that a depreciation deduction is allowed for property used in the taxpayer's trade or business or for property held for the production of income. Treas. Reg. § 1.167(a)-10(b) provides that the period for depreciation begins when the asset is "placed in service." Treas. Reg. § 1.167(a)-11(e)(1)(i) states that property is first placed in service for purposes of the depreciation deduction when it is "placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity or, in a personal activity."

Treas. Reg. 1.167-11(e)(1)(i) then sets forth an example of a building constructed by or for the taxpayer, which building is intended to house machinery and equipment. The regulation provides that such building will be considered placed in service on the date the construction is substantially complete and the building is in a condition or state of readiness and availability to house the machinery. The taxpayer does not have to wait until the machinery intended for the building has been placed in service. The opposite would be the case if the building is essentially an item of machinery or the use of the building is so

closely related to the installation of the machinery that the building could be expected to be replaced or retired when the property it houses is replaced. In this latter case, the building will not be considered to be placed in service until the machinery is in a state of readiness. See also Rev. Rul. 76,238, 1976-1 C.B. 55.

Treas. Reg. § 1.167(a)-2 provides that the depreciation allowance in the case of tangible property applies only to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. The allowance does not apply to inventories or stock in trade

Treas. Reg. 1.46-3(d)(1)(ii) also provides that for purposes of the investment tax credit of section 38, property is considered placed in service when the property is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity. This is the same language as Treas. Reg. § 1.167(a)-11(e)(1)(i). Treas. Reg. § 1.46-(e)(d)(2)(ii) sets forth four examples of property that would be considered to be in a condition or state of readiness and availability for a specifically assigned function. These are:

(i) Parts acquired and set aside during the taxable year for use as replacements for a particular machine. . .in order to avoid operational time loss.

(ii) Operational farm equipment acquired during the taxable year where it is not practicable to use such equipment for its specifically assigned function until the following year.

(iii) Equipment acquired for a specifically assigned function which is operational but is undergoing testing to eliminate any defects.

But the regulation also provides examples of items not in a condition or state of readiness or availability: fruit bearing trees and vines until they have reached an income producing stage and materials and parts acquired to be used in the construction of an item of equipment.

Fundamentally, depreciation represents the exhaustion of an asset as it is consumed in a business. Depreciation deductions should correspond with the time period in which the asset is used to generate income. Commissioner v. Idaho Power Co., 418 U.S. 1 (1974).

There have been many cases applying the ready and available standard of section 167 and its regulations. In Consumers Power Co. v. Commissioner, 89 T.C. 710 (1987), the Tax Court found that an electricity generating unit was not placed in service in 1972, the year for which the taxpayer had claimed depreciation deductions and investment tax credits. In that year, the unit had not yet completed the preoperational testing phase required by the Federal Power Commission and had not been formally accepted by the operator from the subcontractor. The court also observed that even though the unit had generated electrical power during the testing phase in 1972, the amount of electrical power generated was "insufficient to establish that the ... [p]lant was available for full operation on a regular basis in 1972." Id. at 724. It concluded that the unit was not in a state of readiness and availability for its specifically assigned function. Although this quoted clause was not the exclusive grounds for the holding, in referring to the small amount of power output as support for its conclusion, the court implicitly adopted the argument that the unit was not placed in service in 1972 because it did not show sustained, regular generation of electrical power. Relying on Consumers, the court in Oglethorpe Power Corp. v. Commissioner, T.C. Memo. 1990-505 (1990), stated that an electricity generating unit was not deemed to be placed in service in 1981 because it was not available for its specifically assigned function, which the court defined as consistently sustaining generation levels near its rated capacity.

The Service has taken a slightly less restrictive approach relating to "full operation at rated capacity" as a prerequisite for an asset being placed in service when electricity is generated continuously at lower levels as part of a gradual increase over time of energy production levels. See, e.g., Rev. Rul. 84-85, 1984-1 C.B. 10 (stating that although another Revenue Ruling found taxpayer's facility had been placed in service when it was able to operate at rated capacity without failure, this level of operation was not a prerequisite but merely a fact demonstrative of operational status). See also Sealy Power v. Commissioner, 46 F.3d 382 (5th Cir. 1995) (minimal operation of an electricity generating plant fueled by burning trash is sufficient for plant to be deemed placed in service).

Similarly, the system in which machinery is used must be operating before that machinery may be considered placed in service. In Consumers Power, 89 T.C. 710, the upper reservoir component of a pumped storage hydroelectric plant could not be considered placed in service until the entire plant was placed in service because the reservoir and physical plant operated as one integrated unit to produce electrical power. 89 T.C. at 725-26. In Siskiyou Communications, Inc. v. Commissioner, T.C. Memo.

1990-429, telephone switching equipment and toll carriers were not considered placed in service even though capable of performing individual functions because wiring for the systems in which they were to operate had not been completed and employees had not been trained to use the equipment. See also Hawaiian Indep. Refinery, Inc. v. United States, 697 F.2d 1063, 1069 (Fed. Cir. 1983) (two offsite components not considered separately from refinery in determining applicable construction date because all were designed as a single unit and together they functionally formed a single property); Public Service Co. v. U.S., 431 F.2d 980, 983-984 (10th Cir. 1970).

Two more recent cases have allowed depreciation of spare parts before they were installed: Northern States Power Company v. United States, 151 F.3d 876 (8th Cir. 1998), and Connecticut Yankee Atomic Power Co. v. United States, 97-2 U.S.T.C. ¶50,693 (Ct. Cl. 1997). In both cases the courts allowed depreciation for nuclear fuel assemblies in the year received even though the fuel assemblies were not actually installed in and supplying power to the reactors until a few months after delivery in the following fiscal year. Installation took slightly over a month in Northern States and several months in Connecticut Yankee (due to unusual problems). The courts reasoned that they were "ready and available" for immediate use upon delivery, as part of periodic refueling of operating nuclear power generating plants.

These cases arguably merely extend the example in the section 46 regulations allowing immediate depreciation for spare parts of operating machinery. Treas. Reg. §1.46-3(d)(2)(ii) sets forth an example allowing depreciation for spare parts ready and available for operating machinery. Unlike the regulatory example, however, the nuclear fuel assemblies were not acquired as spares to avoid operational time loss in the event of an unplanned malfunction. See Rev. Rul. 81-185, 1981-2 C.B. 59. The regulation also sets forth an example allowing depreciation for a fully operational farm tractor acquired too late in the fall to be used until the following spring. See also Sears v. Commissioner, 359 F.2d 191 (2nd Cir. 1991), which allowed depreciation for an otherwise fully operational barge that could not be currently used due to an uncontrollable act of nature, i.e., a frozen canal. To similar effect, see SMC Corporation v. Commissioner 80-2 U.S.T.C. ¶ 9642 (U.S.D.C. E.D. Tenn.), aff'd, 82-1 U.S.T.C. ¶9309], (6th Cir. 1982) (fully operational shredder and crane deemed placed in service when only electrical connection remained to be completed in a circumstances outside the taxpayer's control and which power was supplied the next fiscal year).

Other authority, possibly contrary, is not on point. In Waddell v. Commissioner, 86 T.C. 848 (1986), rental equipment was deemed placed in service in a rental trade or business when the equipment was first available for lease. Id. at 898. There was no requirement that the rental company operate the equipment it was leasing since rental rather than physical operation was its function from the perspective of the rental company. Id. Similarly, depreciation was not claimed in Piggly Wiggly v. Commissioner, 84 T.C. 739 (1985) until the years in which the equipment was actually installed and used. Id. at 747.

Analysis

Issues 1 and 2

██████████ is not entitled to depreciate the spare ██████████ or the ██████████ for the years at issue on the basis of the statute, regulations and case law. By any measure, neither the ██████████ ██████████ nor the ██████████ were ready and available for use during the years at issue. The system into which the ██████████ and ██████████ were to be used had to be significantly enhanced in order to make them functional at all.

Moreover, the cost of [REDACTED] is very high. The LMSB examiners are currently developing this information with the assistance of an engineer. But for purposes of this advice,

we do have [REDACTED]'s admission that the costs of [REDACTED] are "substantial."

[REDACTED]

Specifically, the Prospectus states:

[REDACTED]

[REDACTED]

[REDACTED], as discussed above, they cannot be said to be "ready and available" in accordance with the rationale of the statute, regulations and case authority.

Moreover, there are other aspects which distinguish the instant case from the two nuclear power assemblies cases, Northern States Power and Connecticut Yankee. The nuclear fuel assemblies were spare parts that merely had to be installed into an existing operating system. No other machinery or equipment had to be acquired and installed in order to activate the assemblies. In [REDACTED]'s case, in contrast, in order to activate the [REDACTED]

or the , the existing system would have to be substantially expanded and enhanced.

. As such, this is not a case of spare parts as intended by the regulatory example. Clearly, if the parts cannot function without a major enhancement and expansion of the system into which the parts are to be placed, by any measure, the parts cannot be said to be ready and available for service.

A second major difference between Northern States Power Co. and Connecticut Yankee and the instant case is the fact that the purchases of the nuclear fuel assemblies there were intended for immediate installation on the upcoming shutdown of the nuclear reactor. So, the time between purchase and installation was one month in the case of Northern States Power and several months in the case of Connecticut Yankee (the longer period because of unexpected delays). The substantial cost of storage of the nuclear fuel assemblies insured that such parts would not be purchased for any long-term holding of the assemblies prior to incorporating it into the operating system.

In contrast, in the instant case, there was no definite date in which to put the and into use.

The basic accounting principle for depreciation is to match revenues stemming from the use of an asset against expenses of that asset. Commissioner v. Idaho Power Co., 418 U.S. 1 (1974). In 's case, the capital assets at issue, the and the are not generating revenue, nor are there plans in the immediate future for the assets to generate such revenue.

This result is contrary to the basic accounting and economic principles underlying tax depreciation in general and the statute and regulations implementing this policy in particular. In such case, the assets at issue should not be subject to depreciation; they are not placed in service. Under all of these circumstances, the [REDACTED] and the [REDACTED] should not be depreciated in the [REDACTED]-[REDACTED] fiscal years. They were not ready and available for use and therefore were not "placed in service for purposes of section 167.

[REDACTED]'s Position

[REDACTED] cites the example in Treas. Reg. 1.167(a)-11(e)(1)(i). This example discusses a building built to house equipment and machinery. In the example, the taxpayer is allowed to begin depreciating the building even though the machinery is not installed and running. By analogy, [REDACTED] argues that because the [REDACTED] and [REDACTED] are in the ground, they should be eligible for depreciation. Presumably, [REDACTED] views the situation as the [REDACTED] will eventually house [REDACTED], and the [REDACTED] will eventually house activated [REDACTED].

This analogy does not work. The conclusion in the example cited is predicated on a building capable of functioning without the machinery in it. In our case, the [REDACTED] is incapable of functioning by itself because its function ties to the installation of the [REDACTED] and [REDACTED] facilities.

Further, in the example in the regulations, the factory equipment is in the process of being installed. As discussed above, there is probably a minimum of [REDACTED] years out for any of the [REDACTED] to be [REDACTED], and probably not even all of them at that time. The time span for activating the [REDACTED] is even more indefinite. As such, the regulation example is not authority for [REDACTED]'s depreciating its [REDACTED] and [REDACTED].

Moreover, the alternative example in the regulation example actually works against [REDACTED]. As an alternative to the example of the building able to function without the machinery, the regulation also gives the example of a building that is essentially an item of machinery or its use is closely related to the installation of the machinery. In this latter case, the building will not be considered to be placed in service until the machinery is in a state of readiness. It is these circumstances that more closely fit [REDACTED]'s [REDACTED]. The use of the [REDACTED] is so closely related to the [REDACTED] and the addition of the [REDACTED] that, under the regulatory example, the [REDACTED] cannot be considered placed in service until these additional parts of the system are installed.

[REDACTED] also argues that its [REDACTED], and should not be divided between [REDACTED] and between the [REDACTED] in use and the [REDACTED]. These assets are merely spare parts of the [REDACTED], awaiting activation. Once the system is operating in any part, all installed parts may be depreciated. In such argument, [REDACTED] would attempt to bring itself under Northern States Power, Connecticut Yankee, and Treas. Reg. 1.47-3(d)(2). For reasons discussed above, this does not work. The [REDACTED] and [REDACTED] cannot operate without enormous additional investment in the system into which they are to be placed: among other things, at least, [REDACTED].

Further, there are no imminent plans to activate the [REDACTED] or [REDACTED]. Thus, these assets are not ready and available as intended by the statute, regulations and case law.

Also, the assets at issue are not minor ones. For example, again only using the [REDACTED] segment, [REDACTED] part of the [REDACTED], the total cost of the [REDACTED] containing the [REDACTED] is approximately \$[REDACTED]. Assuming [REDACTED] retained [REDACTED] of those [REDACTED], its total capitalized base in the [REDACTED] would be approximately \$[REDACTED]. If only [REDACTED] of [REDACTED]'s [REDACTED] were lit, then only [REDACTED] percent of the \$[REDACTED] asset is generating revenue; \$[REDACTED], or [REDACTED] percent, of the asset is on hold. The asset on hold is generating no income, and there are no immediate plans to place the asset into actual operation. Under these circumstances, depreciation should not be allowed.

There are cases and rulings where the ability to depreciate involved the question of components parts compared to the facility as a whole. These cases and ruling delayed depreciation of a components of a system until the whole was up and operating. These cases, however, also do not support [REDACTED]'s position.

Specifically, in Rev. Rul. 73-518, 1973-2 C.B. 54, the Service ruled that a major electrical transmission line was not placed in service, even though it was complete, until the substations at the end of the line were completed and the line could be energized. Similarly, in Rev. Rul. 76-238, 76-1 C.B. 55, where individual units of production machinery and equipment acquired for use in a factory were not placed in service until they were installed in the production line and the entire production line had been completed. See also Gorgonio Wind Generating Co. v. Commissioner, T.C. Memo. 1994-544 (wind turbines installed without several necessary items of equipment were not considered to be in a state of readiness without the equipment).

In all these cases, components of a system were not considered placed in service separately from the system of which they were an essential part. Perhaps on the basis of these examples, [REDACTED] would argue in the mirror image that the [REDACTED] and [REDACTED] are merely components of the [REDACTED]. As the [REDACTED] is operating, so depreciation ought to be allowed for the component [REDACTED] and [REDACTED].

The component versus whole facility cases, however, do not support [REDACTED]'s position. In [REDACTED]'s case, although portions of the [REDACTED] are placed in service and operating, the assets at issue, the [REDACTED] and [REDACTED], are incapable of contributing to the system without further major investments. There is no indication that such was the case with the rulings and cases here. Further, in the case of the major electrical transmission line, while the ruling shows that the system was treated as a whole, the more important thrust of the ruling is that unenergized transmission lines were not considered placed in service until energized. Similarly, [REDACTED]'s [REDACTED] and [REDACTED] should also not be considered placed in service until energized.

Finally, [REDACTED] may be depreciating a small amount of [REDACTED] in its [REDACTED] which it plans to sell. For example, on the [REDACTED] line, [REDACTED]. Of these, it initially transferred [REDACTED] to [REDACTED] under the [REDACTED] Agreement, and another [REDACTED] under another [REDACTED] agreement. According to its published statements, [REDACTED] plans to retain only [REDACTED] to [REDACTED]. Yet, [REDACTED] is depreciating all the remaining [REDACTED]. This is in effect depreciating of [REDACTED]'s inventory. Such depreciation is not allowed.

It is well settled law that the section 167 allowance for depreciation does not apply to inventory or stock in trade. See, Treas. Reg. § 1.167(a)-2; Luhring Motor Co. v. Commissioner, 42 T.C. 732, 751 (1964). Thus, the products manufactured and sold by petitioner in the ordinary course of business are clearly non-depreciable items.

Based on the above analysis, [REDACTED] is not entitled to consider its [REDACTED] or [REDACTED] at issue placed in service during the years at issue.

Issue 3

(b)(5)(AC), (b)(7)a

(b)(5)(AC), (b)(7)a

(b)(5)(AC), (b)(7)a

If you have any questions on this matter, please do not hesitate to contact us.

[REDACTED]
Associate Area Counsel (LMSB)

By

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